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TREASURY FOR S. GOOCH

E.O. 12958: DECL: 02/01/2017
TAGS: ECON EFIN EINV PGOV EC
SUBJECT: WEAKENING ECONOMY MAY BE VULNERABLE

Classified By: DCM Jefferson T. Brown. Reason: 1.4 B and D

¶1. (C) Summary. After six years of solid growth, the Ecuadorian economy will likely slow in 2007, and the Central Bank estimates the economy will grow 3.3%. This may overstate growth, since the economy has a number of vulnerabilities) declining petroleum production and prices, falling business confidence, shrinking trade credit lines, large private sector external debts, and pending expiration of ATPA benefits. Remittances and the petroleum reserve funds could partially offset these weaknesses. Much will depend on President Correa's economic policies. If he defaults on external debt in search of a dramatic debt restructuring or imposes tight controls on domestic banks, Ecuador,s vulnerabilities will be exacerbated, growth will weaken even more, and in the worst case scenario there could be a run on the banks. Conversely, if he seeks only moderate changes for debt and the banking sector, the economy will probably continue to move along at a respectable clip, growing at around 3%. End summary.

It's Been a Good Run

¶2. (U) A common refrain among economic observers in Ecuador is that the economy has performed well since the 1999 banking crisis in spite of recent political instability. The economy has grown an average of 5% annually since 2000, and grew an estimated 4.3% in 2006. Per capita income grew 18% in the last five years, and the poverty rate fell 18 percentage points between 2000 and 2004. The growth and stability are attributable in large measure to dollarization, high oil prices, remittances ($2.7 billion/year), growing non-petroleum exports (annual growth over 14% in 2005 and 2006) and a moderate degree of fiscal discipline (public sector surplus in 2006 exceeding 4% of GDP and $1.3 billion in petroleum reserve funds).

Pessimistic Central Bank

¶3. (C) The Central Bank had been projecting that economic growth in 2007 will be 3.5%. However, in a January 12 meeting with EconCouns, Central Bank General Manager Mauricio Pareja flagged a number of indicators that suggest the economy may be weakening. In particular he noted that since August the Central Bank's forward looking indicator has been at or just below the benchmark that suggests a decelerating economy, and a further decline would foreshadow the beginning of a recession. He noted that the business confidence index

dropped dramatically in November (36 points out of a scale 400; it fell another 10 points in December). He also said that petroleum production is projected to decline six percent, from 196 million barrels in 2006 to 184 million barrels in 2007. Because of falling oil production and prices, he expects that Ecuador will run a small trade deficit in 2007, compared to a roughly $1 billion surplus in ¶2006. In short, he concluded, the economy is showing signs of weakness that could make it vulnerable to policy shocks such as a default or a clampdown on banks.

¶4. (U According to a media article on January 30, the Central Bank has slightly reduced its 2007 growth forecast to 3.3% due to declining oil production.

Caution but not Capital Flight

¶5. (C) The heads of several large Ecuadorian banks, as well as the Central Bank, have told us that they have not seen any signs of capital flight, although they allow that some individuals may have shifted funds and that the banks themselves may have moved more assets offshore. However, Citibank reports that $200 million dollars left as capital flight in the last three week of January. Banks have also noted that deposit growth has slowed down dramatically. We have heard anecdotally from managers from a range of companies that for several months they have been keeping their cash reserves in Ecuador to the minimum needed to meet operating costs. We have also heard assertions that many businesses shelved their investment plans in late 2006, and given the worried comments we have heard from Ecuadorian business leaders we suspect that much of the private sector will remain cautious in early 2007.

Tightening Trade Credit Lines

¶6. (C) The local Citibank chief, Bernando Chacin, said that Citibank is already reducing its trade credits lines for Ecuador. A British-based bank told us that it reduced its Ecuador exposure (mainly trade credits) by one-third prior to Correa winning the presidential election in November. Alberto Dassum, the outgoing president of the Guayaquil Chamber of Industry, told us that suppliers are also beginning to tighten supplier credits by shortening terms and monitoring repayment carefully. He believes that the suppliers, even if they have long-term relations with their Ecuadorian customers, are doing so in response to pressure from insurance companies that underwrite supplier credits. The leaders of Ecuador's business chambers held a press conference on January 25 to highlight their concerns about tightening credit lines, and claimed that trade financing had fallen $56 million in three weeks.

Uncertainty about Trade Preferences

¶7. (SBU) An additional factor, which may or may not hamper growth in the second half of the year, is whether Andean Trade Preferences Act (ATPA) benefits will be extended beyond June 30. Senate President Harry Reid, when he visited Ecuador in December, talked about seeking an additional extension for ATPA. However, if the preferences are not extended, that could have an impact on business confidence as well as the real economy. (The Central Bank estimated that without ATPA Ecuador would lose around $190 million in exports per year, while the Chamber of Industry estimated approximately 105,000 jobs would be lost.)

There's Still Resiliency

¶8. (SBU) As noted above, the Ecuadorian economy has some vulnerabilities, but we don't want to overstate the case. The economy is coming off a year when it grew approximately 4.3% and is carrying at least some momentum into 2007. Oil prices are still reasonably high and above the level used to

calculate the budget, and $2.7 billion in remittances (over 6% of GDP) will help shore up consumer demand. The government will support demand with its plans to increase income transfer payments to the poor. There is also over $1.3 billion in petroleum reserve funds, and the government could also boost investment if it begins to draw on the funds from the former Oxy fields to invest in the hydrocarbons and electricity sectors.

Domestic Vulnerabilities to an International Default
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¶9. (C) A number of international analysts we have talked to believe that the domestic economy will be relatively sheltered if the GOE defaults on external debt. Given the statements on curtailing debt made by President Correa and Economy Minister Patino on the campaign trail and in their first two weeks in office, it appears that they are not concerned about the potential fallout for the domestic economy, although as they settle into office their perspectives may change.

¶10. (C) Most observers, including the Chacin from Citibank, the IMF resident representative, and international analysts, concur that trade credit lines will be cut back dramatically if the GOE defaults, and as noted above, those lines are already beginning to shrink. No one offered an estimate as to what the impact would be on the real economy, but our suspicion is that the collapse in trade finance would be accompanied by additional faltering in business confidence, which would probably slow down economic growth by a percentage point or so. The problems could worsen if ATPA preferences expire at the end of June.

¶11. (C) The IMF resident representative opined that in the case of a default, the Ecuadorian economy would be relatively resilient in 2007 and continue to grow modestly and without a crisis, although he cautioned that some of his IMF colleagues are more pessimistic. He went on to say that in his scenario, the economy would be very weak entering 2008, when there might be a recession and possibly a crisis.

¶12. (C) One relative unknown is the impact a GOE default would have on non-trade private sector external debt. The Central Bank reports that private sector external debt totaled $6.2 billion in November 2006. A default by the government presumably could complicate the private sector's roll-over of this debt, but we do not have a good idea of the implications since the Central Bank does not provide a breakdown on the types or maturities of the debt. The IMF resrep allowed that he does not have a good idea of the composition of this debt, but believes that much of it is used by Ecuadorian companies because of the tax benefits of using debt over equity. He suspects that in the case of an economic crisis, the company owners may walk away from the debt while keeping their personal assets intact.

What About a Domestic Banking Crisis?

¶13. (C) A bigger concern for Ecuador would be if Ecuadorians lost faith in the local banking sector and began a run on the banks. Most analysts, including the IMF resrep, thought that a run would be unlikely if Ecuador were to default on external debt. However, during his campaign Correa raised the possibility of tightening controls over local banks (forced repatriation of offshore assets and/or directed lending). The IMF resrep said if the Correa government imposes restrictions on the banks, the combination of bank controls plus a default might lead to a run on the banks, particularly if the economy were also showing signs of slowing down.

¶14. (C) Citibank,s Chacin said that his bank was beginning to look at scenarios that could lead to a bank run. He said that the studies were not complete, but added that in the 1999 banking crisis the withdrawal of 30% of the system's deposits provoked a crisis. He said that his impression is

that with a dollarized economy a crisis would be provoked with fewer withdrawals, perhaps around 20% of deposits, since it would be harder to meet demand for cash.

Comment

¶15. (C) The Ecuadorian economy will slow from its solid growth over the past six years, given declining oil production and prices as well as falling business confidence. It also shows vulnerabilities that will be exacerbated if the Correa administration pursues policies that further damage business confidence in Ecuador. Despite the risks, perhaps even attracted by them, Correa and his economic advisors seem bent on using debt reduction to mark their government's departure from what they label "neo-liberal" policies of past governments and toward what Correa (and Venezuelan leader Hugo Chavez) refer to as "21st century socialism."

¶16. (C) Correa and his economic team have said that they want to restructure Ecuador's external debt and have suggested they might impose controls on Ecuador's domestic banks. However, to date, it is not clear what they will actually do. If they pursue either policy in a ham-fisted way, they would reduce growth by one to two percentage points in an already slowing economy. Poor implementation of both policies at the same time could very well provoke a banking crisis comparable to that of 1999.

¶17. (C) If the Correa administration pursues debt restructuring in a limited, market-friendly way, and leaves the banks alone or imposes only marginal restrictions, business confidence might stabilize. Even then we suspect that both foreign and domestic investors would remain cautious, given the probable doubts about future economic policies and the outcome of the proposed constituent assembly. However, increased government spending might partially offset reduced private sector investment, while non-petroleum exports and remittances will continue to provide some additional stability. In that case, the economy would probably continue to perform respectably, growing around 3% or so, in spite of the political noise.
JEWELL